Summit Strategies Group

Mitigating Litigation Risk in Defined Contribution Plans

INSIGHTS

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In today's litigious environment, retirement plans are facing a deluge of lawsuits and regulatory fines covering everything from excessive record keeper fees to the appropriateness of certain investment options. It is understandable in this environment that sponsors seek simple solutions to protect them from liability. As a result, Summit has observed the following common refrains among defined contribution (DC) plan sponsors:

> "Why don't we just go all passive in the investment menu?"
>
> "We should simply offer a brokerage window and exclude a core line-up."
>
> "Insured products, such as annuities, are the way to go."

At face value, the above ideas do seem like plausible ways to reduce a fiduciary's risk exposure. Unfortunately, there is no simple panacea that can remove litigation risk or completely absolve a plan sponsor from their fiduciary duties under the Employee Retirement Income Security Act (ERISA)—the above solutions are fraught with their own risks, which will be addressed in sections below.

This paper offers what we believe to be some commonsense and effective methods to mitigate litigation risk within defined contribution plans. These include approaches to plan governance and the creation of a menu of participant investment options. After an extensive survey of the existing literature on the subject, we have found that investment menu design in particular has not been well addressed. And yet, menu design underpins virtually every major class action lawsuit against DC plan sponsors over the past decade.

The number of class action suits against plan sponsors has increased by over 1,000% since 2012.

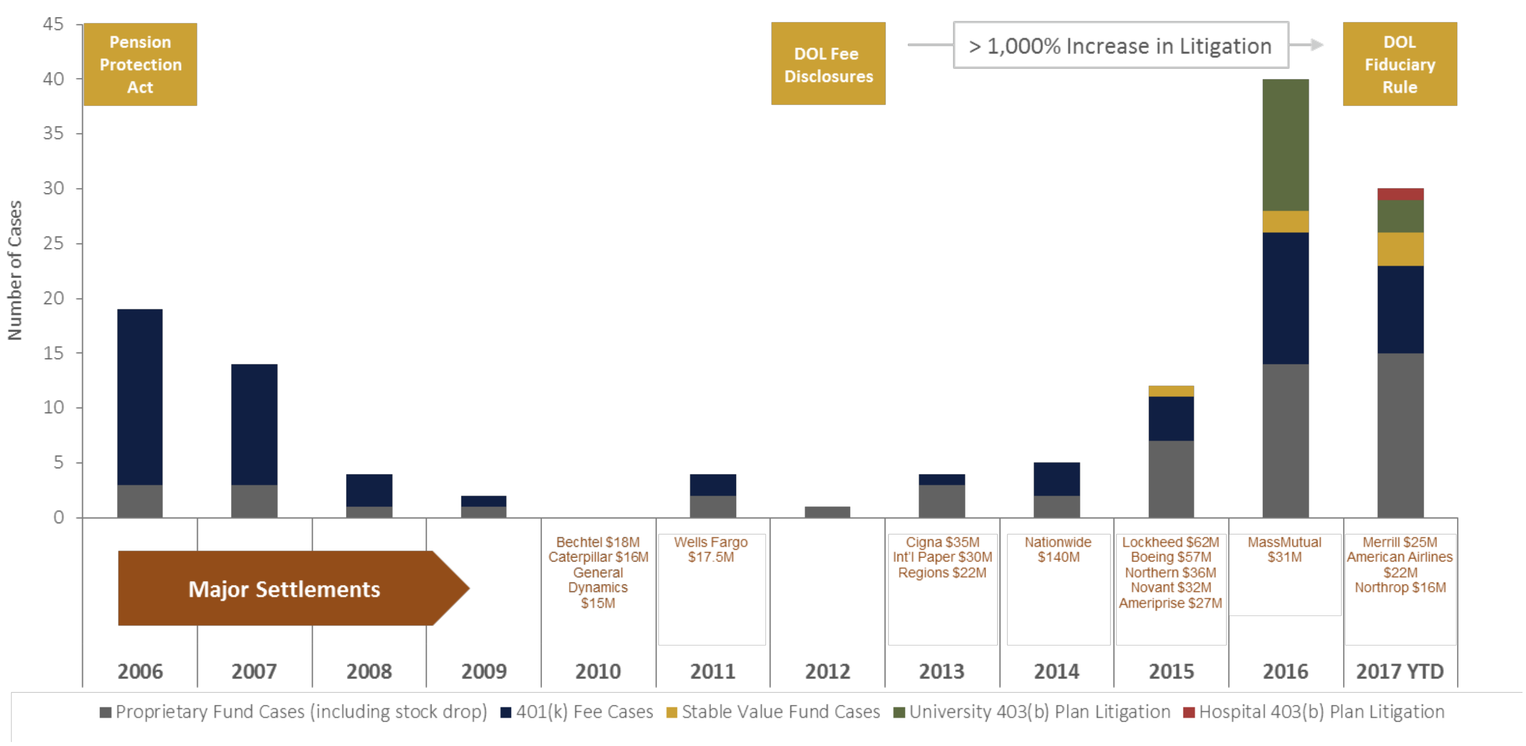
Before delving into the solutions, it is instructive to first examine and quantify the problem, namely the origin and trends within litigation against DC retirement plans. Prior to the year 2000, class action litigation involving DC plans was almost unheard of. A new era of market volatility, starting with the bursting of the tech bubble in 2000 and 2001, changed everything. The tech crash precipitated the first wave of litigation, which started with claims against ENRON and WorldCom concerning employer stock within their 401(k) plans ("stock-drop" cases).

The years that followed saw a dramatic increase in the number, scope and breadth of legal actions against DC plan sponsors. Exhibit 1 illustrates these trends since the second major wave of litigation began in 2006.

Far from being media hyperbole, we can see that increased litigation against DC retirement plans is a real phenomenon. In general, the increase has been due to a confluence of factors, including:

- Growth in DC assets (the majority of which are subject to ERISA) relative to DB plans;
- Government regulations and enhanced regulatory scrutiny; and
- Large settlements, which have led to a more aggressive plaintiff's bar.

Exhibit 1—Growth in Litigation Against Defined Contribution Plans



Beyond these broad conclusions, the chart shows evidence of more nuanced trends:

1. Litigation has evolved from simple stock-drop cases (first round of litigation) to include a variety of claims, with a particular focus on fees charged to plan participants (more on this is detailed in sections below).

2. In general, increases in the number of legal cases have coincided with new regulations of the industry.

   - The Pension Protection Act, which promoted growth of DC plans through participant auto enrollment and the establishment of fiduciary safe harbors for plan sponsors, was a catalyst for the second round of litigation beginning in 2006.
   - The Department of Labor's 408(b)(2) and 404(a) regulations, which called for greater fee transparency between plan vendors, plans and their participants, was a major catalyst for the third round of litigation beginning in 2012.
   - It is widely speculated that the DOL's Fiduciary Rule, implemented in 2017, will spark a fourth round of litigation. The Rule's expanded definition of a fiduciary now includes a much larger and more diverse number of professionals that provide advice or make solicitations to retirement investors. These newly deemed fiduciaries are therefore considered fresh targets for potential litigation.

3. Settlements reached from such cases have involved significant sums, including a $140 million settlement against Nationwide in 2014 (not including legal fees!).

4. Initially limited to large corporate 401(k) plans, today's cases now include hospital and university 403(b) plans as well as smaller DC plans.

And while the total number of plans involved in litigation still represents a tiny fraction of the industry, sponsors should pay close attention to these trends. The large monetary sums involved in settlements, substantial legal fees, the potential damage to a company's reputation and the fact that plan sponsors may be personally liable for breaches of fiduciary duty under ERISA, mean that sponsors are placing themselves in jeopardy if they ignore these trends.

Mitigating Litigation Risk Through Good Governance

While nothing can guarantee that a sponsor will not be sued, there are some simple steps sponsors can take to significantly lower their risk and be better prepared in case a suit does arise. The first, retain expert advice if the plan sponsor lacks it internally. The second, establish a structured process for undertaking fiduciary duties according to a timeline (i.e., good plan governance).

Virtually all the previous legal cases have alleged that plan sponsors have breached their fiduciary duty of prudence under ERISA. Prudence, as interpreted under ERISA, is a matter of following a logical and thorough process, irrespective of what the outcomes of that process may be. The process itself is guided by what a person familiar with the subject matter would follow (i.e., an experienced investment professional). For example, per the DOL's guidance, "an investment does not have to be a 'winner' if it was part of a prudent overall diversified investment portfolio for the plan." (*Profit Sharing Plans for Small Businesses*, the Department of Labor, https://www.dol.gov/ebsa/publications/profitsharing.html).

Summit Recommendation—Plan Design

Plan design plays a crucial role in helping DC plan sponsors mitigate litigation risk. Summit is an advocate for adhering to 404(c) compliance (absolving the sponsor of liability from participant investment decisions) and the designation of a Qualified Default Investment Alternative (absolving the sponsor of liability in the event that a participant fails to make an investment election and is defaulted into a designated plan investment).

The bottom line is that many sponsors have been unable to demonstrate that they followed a logical process with respect to administering their plans. If they had been able to do so, many rulings may have gone the other way. Once again, the DOL has clearly stated that a fiduciary's duties under ERISA are related to "the process used to carry out the plan functions rather than simply the end results" (*Profit Sharing Plans for Small Businesses*, DOL).

We believe it is equally important that any such process be informed by trends in litigation against DC plans. In our research, we have observed several common allegations:

1. Excessive Investment Fees—Plan sponsors fail to offer institutional share classes and/or less expensive investment vehicles that would result in fee savings for participants.

2. Opaque Revenue Share Fee Models—Arrangements that result in excessive fees paid to the record keeper and/or surpluses of revenue that are not rebated to participants or spent on plan services by the following tax year..

Summit Recommendation—Eliminating Revenue Share Impact

Summit has transitioned many clients to a zero revenue share investment line-up or one where fund revenue share is fully rebated back to participant accounts. In all cases, Summit advocates the transparent and direct billing of plan costs to participant accounts. This has resulted in the reduction of our clients' investment fees by as much as 30% for participants.

3. **Excessive Record Keeper and Plan Administration Fees**—Plan sponsors fail to regularly benchmark fees and leverage a plan's scale.

4. **Underperforming Funds**—Plan sponsors fail to terminate underperforming managers and/or neglect to document the rationale for retaining managers that fail criteria established in their plan's Investment Policy Statement.

5. **Absence of a Process for Determining Active Versus Passive Investment Funds**—Actively managed funds carrying higher expenses that fail to demonstrate performance benefit are indiscriminately selected over less expensive index funds.

6. **Offering Company Stock and Riskier Sector-Specific Funds**—Concentrated allocation risk can lead to poor investment results.

7. **Opaque Stable Value Structures**—Stable value funds that fail to provide a transparent crediting rate formula.

Summit Recommendation—Transparent Stable Value Funds

Summit has developed innovative solutions in response to stable value products that do not publicly disclose crediting rate formulas, the subject of multiple lawsuits since 2015. On behalf of a large hospital 403(b) plan, Summit together with the client's record keeper developed a new stable value product featuring industry-leading transparency. The new product was a first of its kind in that it was structured as a separate insurance account with a guaranteed minimum rate and also offered a fully transparent credit rate formula.

8. **Too Many Investment Options**—Plan sponsors offer participants 40, 50, 60 or more investment options, which may add to overall participant investment fees and/or cause participant confusion, leading to poor investment decisions.

9. **Complex Investment Options**—Complex options in a plan's investment menu may lead to unexpected investment losses due to participants' misunderstanding of inherent risks.

10. **Proprietary Funds**—Proprietary funds offered by the record keeper may be a conflict of interest due to the inclusion of indirect and/or non-transparent fees, or the availability of lower cost equivalent options in the market.

A structured fiduciary process that addresses the above trends can be one of the best ways to mitigate litigation risk. By focusing on a different aspect of plan administration each quarter, and related fiduciary duties, plan sponsors can ensure their plan is on track to follow industry best practices. Documenting the process and revisiting it each year is as important as establishing a process.

Exhibit 2 illustrates our recommended process to ensure important fiduciary responsibilities are tended to on a regular basis.

Summit Recommendation—Good Governance

Many of Summit's clients have sought guidance in regard to the creation of a formal governance process. The process depicted in Exhibit 2 has been designed by listening to our client's needs as well as our own research into industry best practices. We often modify this process based on the frequency with which a plan sponsor conducts their retirement plan committee meetings.

Exhibit 2—Summit's Guide to Good Governance

1st Quarter—Governance Review

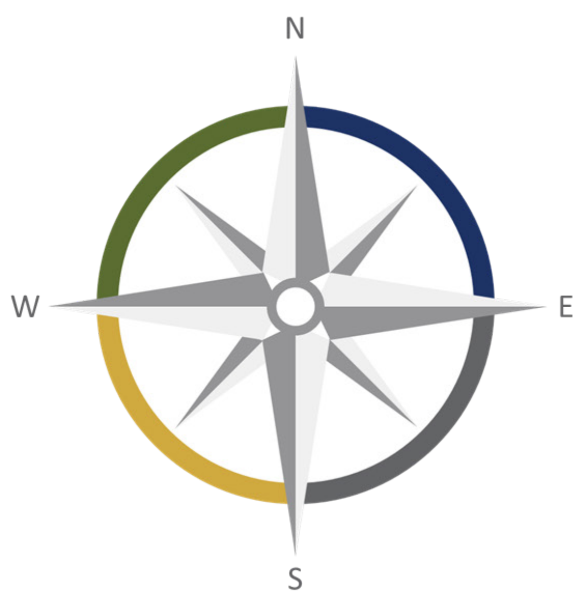
- Evaluate and update IPS
- Review plan documents
- Revisit fiduciary insurance coverage
- Refresher courses on fiduciary duties

Quarterly Investment Review

2nd Quarter—Fee Review

- Investment fee benchmarking
- Share class/investment vehicle review
- Revenue share evaluation
- Review 404(a) / 408(b)2 disclosures

Quarterly Investment Review



3rd Quarter—Investment Review

- Review watch list of underperformers
- QDIA Review—Target Date / Target Risk
- Stable value evaluation
- Refine investment menu if needed

Quarterly Investment Review

4th Quarter—Vendor Review

- Record keeper fees and service evaluation (RFI/RFP every three years)
- Review managed account provider and brokerage window (if applicable)

Quarterly Investment Review

Mitigating Litigation Risk Through Investment Menu Design

Investment menu design (i.e., offering the right type and number of investment options and services to participants) also can serve to significantly reduce litigation risk in DC plans. Again with a view toward the preceding analysis of litigation trends, Summit recommends adoption of the following principles when creating an investment menu for a DC plan.

Offer Low Fee Investments

Excessive investment fees are at the heart of many legal cases against plan sponsors. The main culprits in these cases are normally the plan sponsor's inclusion of higher fee mutual fund share classes that offer revenue share to offset the cost of recordkeeping, and/or the failure of plan sponsors to regularly evaluate the marketplace for less expensive investment vehicles (including zero revenue share mutual fund share classes, collective investment trusts or separately managed accounts).

As such, plan sponsors should focus on both revenue share embedded in their funds and relatedly, the investment vehicles offered to participants. Funds that offer revenue share are a lightning rod for litigators because they have higher fees than share classes for which the plan would normally qualify. A plan's investment menu and assets can be looked up easily in its Form 5500, which are readily available on public websites. This is one of the first things many law offices do when investigating plans to determine if there is any "low hanging fruit" ripe for litigation.

To prevent this, Summit recommends that plans move to the least expensive mutual fund share classes for which their plans qualify, directly bill plan costs to participants in a transparent manner, rebate all remaining fund revenue share to participant accounts on at least an annual basis, and consider lower cost investment vehicles such as collective investment trusts (CITs).

Summit Recommendation—Lowest Cost Share Classes

Summit has developed a proprietary application that automatically evaluates our clients' investment line-ups to determine if their plans qualify for lower cost share classes on a quarterly basis.

Another simple solution to mitigating litigation risk over excessive investment menu fees is to offer participants a core passive line-up in major asset classes (US Large Cap, US Small Cap, Total International, Core Fixed Income) to complement active managers. This not only serves to lower average plan investment costs, but also gives participants the option to avoid higher fee investments.

Avoid Excessive Risk

Another focus of litigators is high-risk actively managed funds, which usually charge higher fees than their passive counterparts. Despite this focus, Summit believes that active management still can prudently co-exist with passive funds in a defined contribution plan. There is a wealth of evidence that demonstrates that active management, even in higher fee mutual fund vehicles, has consistently added alpha in certain asset classes, particularly those that are less efficient and have less analyst coverage (e.g., small cap and emerging markets equities).

That said, Summit makes specific recommendations to clients when employing active managers in a DC plan:

1. It is crucial to document the rationale for active vs. passive management in each asset class. In general, we recommend that the default position should be passive management. Active management should then only be employed in asset classes where active management has proven to add value over the long term net of fees. Again, the sponsor should document such analysis where applicable.

2. Where active funds are offered, select lower tracking error managers to reduce the possible magnitude and duration of underperformance, limit expensive manager turnover in the line-up, and prevent market timing behavior among participants. Remember, unlike a defined benefit plan, DC participants may not be sophisticated investors, do not have an infinite investment time horizon as a going concern, and their losses are not insured by any organization such as the Pension Benefit Guarantee Corporation. Therefore, higher risk investments that populate DB plans are often not appropriate for DC participants.

3. Eliminate higher volatility concentrated sector funds or offer them solely as part of a diversified multi-asset class fund (e.g., a target-date fund).

Summit Recommendation—Avoid Excessive Risk

Summit has worked with several clients to consolidate multiple higher risk inflation-hedging and sector funds into diversified real asset and equity funds within their investment line-ups.

4. Eliminate company stock or pair with an intensive education campaign, position limits and/or investment advice services.

Keep it Simple

This cannot be emphasized enough. Added complexity in a line-up can lead to all sorts of issues that can expose a plan to litigation. There is simply no need to offer participants significantly more than 18 to 20 investment options to create a well-diversified core investment line-up (18 to 20 funds is the current average number of options offered by DC plans. Source: PSCA 2016, Deloitte 2017). In fact, there is a wealth of evidence in behavioral finance that suggests doing so causes more harm than good.

Moreover, the provision of too many investment options in a menu e.g., 40, 50, 60 or more options, has been the basis of numerous lawsuits, especially against university 403(b) plans. Fortunately, this is a fairly easy situation to remedy from an investment menu perspective. We recommend:

- Diversified Qualified Default Investment Alternative (QDIA)—This can be in the form of Target Date Funds, Risk-Based Portfolios or Managed Account Services. These types of options are recognized by the DOL as appropriate and absolve the plan sponsor of fiduciary liability if a participant is defaulted into the QDIA option.

Summit Recommendation—Diversified QDIA

Summit recommended that a client change its plan QDIA from a higher risk Global Tactical Asset Allocation fund carrying an expense ratio of 80 bps to the line-up's existing target-date fund suite with expenses totaling 14 bps (83% fee savings). The change also resulted in participants shifting into more age-appropriate asset allocations.

- Simple Retirement Income Solution—Any retirement income solution should start with a simple premise that has nothing to do with the actual investment option offered: the plan must have the ability to provide participants with systematic withdrawals from their accounts in retirement. This is a service offered by many, but not all, record keepers. If a participant is required to take a partial or full lump sum distribution from their DC plan in retirement, then any product providing retirement income is virtually meaningless. Once systematic withdrawals are permitted, then the issue of product becomes germane. Here again, Summit recommends simple solutions paired with good financial planning tools: a target-date fund that focuses on income in the retirement portion of the glidepath; a government money market fund accompanied by a short-term bond fund and/or a TIPs fund; a stable value fund paired with similar added inflation protection.

- Diversified Options in Broad Market Asset Classes—Too often we see investment line-ups that have a fund for every sector in the style box. Beyond creating participant confusion, this approach often leads to investment style and holdings overlap which creates risk concentrations in the line-up. A better approach is to offer participants non-overlapping investments in broad market asset classes.

If more complex line-ups are preferred, Summit recommends the employment of a 3(38) fiduciary consultant that assumes 100% of the liability for the creation and maintenance of the investment line-up. In this way, plan sponsors can offload the additional fiduciary risk associated with their more complex investment menu. Examples of such a line-up may include a suite of multi-manager white label funds.

Offer Participants Investment Advice

One of the best practices a plan sponsor can do to help participants secure better retirement outcomes is to offer investment advice services. Such services can help the sponsor avoid many of the common pitfalls that can lead to litigation, provided that the advice services are appropriately monitored. For example, the inappropriate concentration of higher risk investments in participant accounts, which can lead to lawsuits if those investments perform poorly (e.g., stock-drop cases), can be significantly reduced through the provision of fiduciary advice services.

Summit Recommendation—Fiduciary Investment Advice

A major component of a Summit's record keeper evaluation services, including development, submission and analysis of Requests for Proposals, is to evaluate each provider's participant advice services (i.e., managed accounts, one-on-one counseling and participant communications).

Some plan sponsors are reluctant to offer these based on a belief that they are liable for the advice given to participants. This is simply not the case. A plan sponsor is required to have a process in place to monitor vendors providing services to the plan. The vendor itself is the fiduciary over the advice provided. Instead of increasing a plan sponsor's risk, advice can reduce risk by facilitating good investment decisions among a plan's participants.

Advice can be provided in many ways to participants and ultimately should be informed by participant behavior (e.g., Do participants utilize existing services offered by the plan? Are participants highly engaged with the record keeper's call center? Do they prefer online interactions or face-to-face meetings?). The plan sponsor's goal should be to ensure that the greatest number of participants actually utilize the advice services offered to them. This may mean that a record keeper's call center is sufficient to offer advice if your participant population demonstrates a pattern of being highly engaged. In the event that your population is not highly engaged, making a managed account service the default investment option in your plan may help ensure your participants avail themselves of advice services. Check with your record keeper to see what options are available to your plan.

Conclusion

Returning to the beginning of the paper, it is helpful to revisit some of the common refrains among plan sponsors in mitigating fiduciary risk.

"Why don't we just go all passive in the investment menu?"

While offering an all passive line-up is a tempting proposition based on the substantial reduction of fees in the investment menu, it does not absolve the plan sponsor of its fiduciary duty of prudence when selecting investments for the plan. Given the evidence of active management's ability to add consistent value net of fees in certain asset classes, is it prudent to simply go passive everywhere? The opposite is also true: given active management's struggles to add value in certain asset classes after fees, is it prudent to go all active in the investment line-up? Regardless of the ultimate decision, in all cases the plan sponsor must document the rationale for active or passive management in each asset class.

Summit Recommendation—Active versus Passive

Summit has conducted extensive research to identify asset classes where active management has added consistent alpha over time *on a net-of-fees basis*. This analysis includes assessment of different investment vehicles as their fee structures can have a significant impact on outcomes (e.g., institutional and retirement mutual funds, collective investment trusts, separately managed accounts). Our research is incorporated into all manager search and selection processes for DC plans.

"We should simply offer a brokerage window and exclude a core line-up."

The motivating factor here is that plan sponsors are not liable for monitoring investments offered through a brokerage window to participants. However, what may be a good idea for plans that have a smaller number of sophisticated investors (e.g., law firms, medical practices, investment companies), is a bad idea for the majority of plans. The fact is that most brokerage windows offer hundreds of investments by design, offer retail share classes that include fund revenue share, tack additional loads onto non-proprietary options and institutional share classes—which a participant could purchase for lower fees within a core line-up—and may not offer participants any advice services. In short, if offered as the only investment option available to participants that include unsophisticated investors, a brokerage window is an enabler of bad participant investment decisions and is a target-rich environment for litigators.

"Insured products, such as annuities, are the way to go."

Maybe in the future, but not yet. Insured products, such as annuities, present substantial risk to plan sponsors at present. The issue? Aside from high and non-transparent fees, plan sponsors are required to monitor the solvency of the underlying insurer for the life of the annuity product in the plan. Until the DOL issues some kind of safe harbor regulations for plan sponsors, this is simply not a risk that the majority of sponsors are willing to accept.

As can be seen, the above "solutions" are fraught with their own risks, which can easily expose plans to litigation. Ultimately, we believe that by following the governance processes and structural investment recommendations in this paper, plan sponsors may effectively mitigate litigation risk.

Summit Strategies has extensive experience helping sponsors successfully reduce litigation risk and secure better retirement outcomes for their participants. Our goal is to help clients achieve the benefits of what a defined contribution plan is really meant to offer: the ability to better manage a workforce, improve operational efficiencies and labor productivity, reduce labor costs over the long-term and retain top-quality employees.

About the Authors

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About Summit Strategies Group

Summit Strategies Group is one of the industry's leading investment consultants focused on developing long-term partnerships with institutional investors. Founded in 1995, we have been serving our clients, including endowments and foundations, hospitals and health care systems, public funds and corporations (defined benefit and defined contribution plans), for more than 20 years.

We provide traditional full-service consulting, defined contribution and outsourced CIO services. Our extensive in-house resources and research capabilities enable us to help clients meet their investment objectives. We have highly experienced professionals in the areas of consulting, capital markets and risk management, manager research, operational due diligence, and performance measurement and analytics.

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